Madorin v. Commissioner, 84 T. C. 667, 1985 U. S. Tax Ct. LEXIS 94, 84 T. C. No. 44 (1985)

Terminating grantor trust status results in a taxable disposition of trust assets by the grantor, with gain recognized as ordinary income if the trust's underlying partnership has unrealized receivables.

Summary

Bernard Madorin established four trusts that invested in a partnership, Metro, which in turn invested in Saintly Associates. As grantor trusts, Madorin reported the trusts' losses. When the trusts became profitable, the trustee renounced the power to add beneficiaries, ending grantor trust status. The IRS argued that this change triggered a taxable disposition of the partnership interests by Madorin to the trusts, with the gain treated as ordinary income due to Saintly's unrealized receivables. The Tax Court upheld the validity and retroactive application of the relevant regulation, ruling that the disposition was taxable and the gain was ordinary income.

Facts

Bernard Madorin established four irrevocable trusts in 1975, each funded with $5,075 and designated Richard Coen as the nonadverse trustee. The trusts invested in Metro Investment Co. , which then invested in Saintly Associates, a partnership servicing motion picture production. Madorin reported the trusts' losses on his tax returns until 1978 when Coen renounced his power to add beneficiaries, ending the trusts' grantor trust status. At this point, the trusts ceased being treated as owned by Madorin for tax purposes. The IRS assessed a deficiency, arguing that the change in trust status triggered a taxable disposition of the partnership interests held by the trusts.

Procedural History

The IRS issued a notice of deficiency to Madorin in 1981, asserting a tax deficiency based on the disposition of the partnership interests when the trusts ceased to be grantor trusts. Madorin petitioned the U. S. Tax Court, challenging the validity and retroactive application of the regulation used by the IRS, as well as the characterization of the gain as ordinary income.

Issue(s)

1. Whether the regulation treating the termination of grantor trust status as a taxable disposition of trust property is valid.
2. Whether the regulation should be applied retroactively.
3. Whether the gain recognized upon the disposition should be treated as ordinary income or capital gain.

Holding

1. Yes, because the regulation is a valid interpretation of the relevant statutory provisions, treating the grantor as the owner of trust property for tax purposes.
2. Yes, because the retroactive application of the regulation was not an abuse of discretion by the IRS, and taxpayers were on notice of the IRS's position.
3. Yes, because the gain is attributable to the unrealized receivables of the underlying partnership, Saintly Associates, and should be taxed as ordinary income under sections 741 and 751.

Court's Reasoning

The court upheld the regulation, reasoning that it was a valid interpretation of sections 671, 674, and 1001. The regulation treated the grantor as the owner of the trust's assets, consistent with the ordinary meaning of "owner. " The court rejected arguments that "owner" should be limited to attributing income, deductions, and credits, finding no clear legislative intent to limit the term's meaning. The court also distinguished cases where a grantor trust's separate entity status was recognized for specific statutory purposes, emphasizing the need to prevent tax avoidance through trust arrangements. The retroactive application of the regulation was upheld, as taxpayers were on notice of the IRS's position through a 1977 Revenue Ruling. Finally, the court ruled that the gain should be ordinary income because it was attributable to unrealized receivables in the underlying partnership, Saintly Associates, and the use of an intermediary partnership, Metro, did not change this result.

Practical Implications

This decision clarifies that terminating grantor trust status can trigger a taxable disposition of trust assets, requiring careful planning for trust arrangements involving partnerships. Practitioners must consider the potential for ordinary income treatment when trusts hold interests in partnerships with unrealized receivables or inventory. The ruling also underscores the IRS's authority to apply regulations retroactively, even when they clarify existing positions. Taxpayers using grantor trusts to invest in partnerships should be aware of the potential tax consequences of changing the trust's status and the need to report any resulting gain. Subsequent cases have applied this ruling to similar fact patterns, reinforcing its significance in the taxation of trust and partnership arrangements.

